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October 22, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
Regs.comments@occ.treas.gov
Docket ID OCC-2012 0008

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
Regs.comments@federalreserve.gov
Docket R-1442

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@FDIC.gov
RIN 3064-AD95

RE: Basel II Proposals: Regulatory Capital and Standardized Approach

Heads of the Agencies:

Thank you for the opportunity to comment on the Basel III proposals.

As a bit of background, our company is a locally-owned $2 billion community banking company. We are headquartered in Denver, serving borrowers, depositors and trust customers in Colorado, Wyoming and Kansas City through our bank subsidiary, ANB Bank, a state-chartered member bank. Although we have locations in large metro areas, we also serve many small or rural communities such as Rifle, Colorado and Worland, Wyoming. As a community bank that emphasizes relationship banking, we serve many small business customers as well as individuals.

Our company has spent many hours reviewing the Basel III proposals and working to understand their impact. Our comments below address the six of the issues most critical to community banks' ability to continue to serve customers economically, and in a safe and sound manner. The attachment itemizes some additional, more detailed concerns with these and other topics in the NPR's.

1. **Including unrealized gains and losses on AFS securities in Common Equity Tier 1 capital** (Questions 1, 15 and 16 in Regulatory Capital)

   The existing OTTI mechanism to account for true credit losses is not broken; it works well. Including unrealized gains/losses in Common Equity Tier 1 would be damaging both to our local economies and to safe and sound banking and have seriously negative unintended consequences.

A. It would impede community banks' ability to serve their borrowers and their communities.

i. The change in Tier 1 capital would flow directly through to banks' legal lending limits to individual borrowers. Every bank will be affected at the same time, to a greater or lesser degree, when interest rates rise. Significant borrowers in our communities whose borrowing needs easily fit inside the lending limits of local banks will find all of a sudden that their ability to renew their operating lines of credit has been significantly reduced simply due to fluctuations in the Treasury bond markets. For our bank alone, a "normal" 300 basis point uptick in interest rates would reduce the amount we could lend to a single borrower by approximately 40%[1]. Slightly over 10% of our bank's loan commitments are to borrowers whose credit we would need to curtail at renewal in order to meet the lower lending limit imposed by an interest rate increase of even this relatively small magnitude.

The substantial business borrowers that would be affected also tend to be the substantial employers in their local communities. What is the purpose and what is the true benefit of whipsawing the availability of credit to those businesses?

ii. We are a very well-capitalized bank with $180MM in Tier 1 capital, and a conservative average life in our securities portfolio of about three years. That "normal" rate increase of 300 bp's will cause $75MM of our bank's capital to simply disappear. That $75MM can support about $640MM in lending to all borrowers, not just the largest of our local businesses. That effect will be multiplied since virtually all banks in a community will be driven at the same time to shrink their balance sheets in line with their reduced capital levels. This will be very pro-cyclical and undermine economic stability in our markets.

Here is a real-life example of the potential impact in some of our smaller communities: In 2002-3, a major employer in one of our rural Wyoming towns—the local ag processing plant—ran into financial difficulties and needed a substantial loan. All the banks in the community (5 at the time) pooled their lending resources to make the loan that was pivotal in keeping that plant open. That loan was made at a time when interest rates were rising steeply, and unrealized securities losses were the norm. Had this proposal been in effect, the "double whammy" of a lower lending limit combined with banks' need to shrink their overall balance sheet could have made it very difficult for that town's banks to be able to come together to provide credit to a pivotal local employer.

iii. This would push borrowers away from community banks towards the larger "systemically important" banks whose lending limits are much larger and who have more sophisticated abilities to hedge their portfolios. Yet community banks are exactly the ones who know their local markets and credit conditions the best.

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[1] Typical interest-rate cycles in past years have come in roughly 300 basis point increments. Figures cited assume this increase comes as an immediate shock, and are calculated on a fully phased-in basis excluding the impact of other changes to Tier 1 such as the disallowance of Trust Preferred.

B. It restricts banks' ability to do exactly what banking regulators are seeking—proper interest-rate risk management, strong liquidity management and good capital planning.

i. The central challenge for bank portfolio managers is to manage the balance between risk and reward for each of their securities, every day. However, if portfolio managers need to artificially protect capital levels by taking securities out of the available-for-sale category, their ability to manage liquidity risk, interest-rate risk and credit risk will be materially reduced.

ii. Banks that take a more prudent and conservative approach to lending and maintaining conservative levels of on-balance sheet liquidity will be penalized relative to more aggressive banks when interest rates rise (as they inevitably will). Banks with conservative loan-to-deposit ratios, and thus a higher proportion of securities, (largely government-backed for most banks) will see their measured capital decline sharply when interest rates rise, as the loss in market value of their bonds is taken out of Tier 1 capital; banks with more-aggressive loan levels (and thus more risk) will see a much lower reduction in Tier 1 capital. This is paradoxical.

iii. Capital planning will become extremely difficult. 40% of our well-managed bank's Tier 1 capital could disappear overnight in a major selloff in the Treasury markets[2], pushing our bank below well-capitalized even if none of the other changes to Tier 1 changes are implemented. How can even the best bank managers feel comfortable that they have provided a prudent capital structure for their institution when a bank such as ours could go from well-capitalized to under-capitalized virtually overnight, even though the bank's credit profile has worsened not at all?

iv. Finally, regulators have recently required banks to begin fully marking to market their balance sheets via Economic Value of Equity (EVE) modeling. Great emphasis has rightly been placed on this process. If regulators are concerned about a bank's ability to absorb losses in an adverse interest-rate scenario, they should focus on the comprehensive picture provided by EVE, and not look strictly at a single portion of the balance sheet. Partial mark-to-market is a square peg in a round hole.

2. **Eliminating Trust Preferred from Additional Tier 1 Capital** (Questions 1 and 17 in Regulatory Capital)

The proposal goes far beyond what Dodd-Frank requires and phases out Trust Preferred as Tier 1 capital for all banking companies, not just those over $15 billion.

A. This sends exactly the wrong signal to markets.

[2] I.e. the 300 bp rate shock referenced earlier.

Banks that prudently shored up their capital on their own by tapping the Trust Preferred marketplace will be penalized for that decision to participate in the private market for capital. By contrast, banks that did not manage their capital prudently and turned to a government bailout with TARP dollars have that government bailout money permanently grandfathered as Tier 1 capital.

B. <u>To the extent that Trust Preferred has been problematic, other regulatory actions have largely dealt with the problem:</u>

   i. Dodd-Frank disallowed counting any <u>new</u> Trust Preferreds in capital.
   ii. Congress has already decided to disallow <u>existing</u> Trust Preferreds in Additional Tier 1 capital for the largest banks.
   iii. The addition of a Common Equity Tier 1 requirement, <u>which we support</u>, combined with the fact that existing regulation limits Trust Preferred to a total of 25% of Tier 1 capital, means that Trust Preferred will shrink as a component of industry capital over time even if this phase-out proposal is not adopted.

However, Trust Preferred does remain a valuable source of low-cost capital that supports lending in existing community banks. Our lesser size and lack of name recognition means we cannot raise publicly-issued stock on competitive terms with the largest banks whose shareholders are perceived in the markets to be guarded by the "systemically important" designation. <u>If instead we retain earnings to replace our Trust Preferred, it would consume every penny of our after-tax earnings for the next six and a half years.</u> [3] That is capital that is not available to support increased lending, expanded risk weightings or the increase in required capital ratios.

If regulators nonetheless decide to phase out Trust Preferreds over the current proposal of 10 years, we would suggest an alternate phase-out formula, one which builds on the existing limits. We suggest progressively scaling down the existing 25% limit of Tier 1 capital by 1.25-2.5% per year. This has the virtue that a) bankers who do raise additional common equity can use at least some of that capital for growth or to meet the other new requirements of the proposal while still b) progressively reducing the share of Trust Preferreds in a banking company's overall capital mix.

3. <u>**The proposals focus on Tier 1 as a primary solution for every credit area that is perceived in today's environment to represent added risk; supervision and proper loan-loss reserve levels in reality are equally important.** (Question 1 in Regulatory Capital and Standardized Approach)</u>

It is only when supervision and proper loan-loss reserves have failed that banks need to fall back on Tier 1 capital.

A. Regulators have a host of supervisory tools to use to restrain excessive risk-taking by banks, including requiring management to improve its underwriting practices, using

[3] Based on 2012 YTD earnings

the existing CRE concentration guidance, requiring banks with excessive concentrations to increase their capital ratios, and so forth.

B. Regulators concerned about banks being capitalized to withstand risky credits should first ensure that these exposures are being properly reserved for. That will accomplish far more than changing capital risk weights for certain loan types. Proper reserving dwarfs the capital increase required under the proposal[4].

C. By selectively changing a host of risk weights in response to today's hot-button issues, the proposal ignores the fact that credit risks run in cycles. Thirty years ago, it was farm lending that was perceived as high-risk and brought down many banks; then it was third-world debt and a few years later the focus was on highly-leveraged corporate buyout loans. In the next downturn, it will be something else. Enshrining certain loan types as needing higher than 100% risk weights will always be fighting the last war and providing false re-assurance.

D. Moreover, the types of loans singled out for above-100% risk weights are secured lending. Why would it ever make sense to risk-weight secured loans over 100% when unsecured loans such as credit-card lending get 100%? In '07-'11, loss rates on credit-card loans vastly outpaced loss rates on loan portfolios as a whole, by a multiple ranging from 208% ('11) to a high of 805% ('07).[5]

4. **The proposed changes in risk weights on loans secured by single-family residences, when combined with all the new compliance regulations on such lending, will have significant unintended consequences for the future of small business credit as well as consumer loans.** (Questions 1, 2 and 5 in Standardized Approach)

Loans secured 51% or more by single-family residences are a key element of our lending, as they comprise fully 25% of our bank's loans outstanding.

Basel I properly characterized most loans as 100% risk weight. We believe that the limited exception made at that time for up to 89% LTV closed-end senior liens on SFR's (or combined 1st/2nd on the same property) to be risk-weighted at 50% continues to make sense. Even in the depths of the recent housing-led recession, senior liens on SFR's continued to be the lowest loss-rate category in our entire bank (about one-third the loss rate for all other types of credit).

A. The proposal takes a very broad-brush approach to a fairly narrow problem that is likely to do more harm than good, as described below. In support of the higher risk-weight proposal, the agencies cite five causes of losses in single-family lending.

[4] Based on our experience, at least 20% of the loan should be expensed out of Tier 1 and put in the ALLL when a loan goes on non-accrual, and often more. All of that Tier 1 reduction has to be replenished to maintain Tier 1 ratios. This proposal means banks would need to add just 4.25% to Tier 1 to maintain an 8.5% Tier 1 risk-based ratio when a loan goes nonaccrual; compared to the amount required for proper reserving, this latter provision accomplishes almost nothing.

[5] UBPR, all banks in nation.

Only two are problems that might properly be addressed by higher risk weights (teaser rate/negative-am loans and low/no-doc loans)[6]. Those problems are already being addressed via the new and existing consumer-protection and compliance provisions, safety-and-soundness exams, and increased provision to the ALLL.

However, the proposal goes far beyond addressing these problems. Increased capital requirements for all banks, the large majority of whom did and continue to do business the right way, is not the right solution for the real problem.

B. The current LTV- and performance-based risk weighting works well. However, the proposal significantly expands the risk weights well above 100% and incorporates numerous additional criteria to the risk-weighting for even low risk-weight loans. These changes a) do not add to safety and soundness and b) will have significant unintended consequences.

For example, many small business owners use their primary residences as part of a larger collateral package (including life insurance, inventory, etc.) for loans to invest in their businesses. Approximately 10% of our single-family residential loans include such secondary collateral. These loans are generally custom-structured on terms specifically appropriate to those cash flows from these borrowers, including prudent use of floating rates and balloon payments, such as are normal practice in commercial credit.

The very low risk of these loans is evidenced by our low loss rates noted above. Yet not only would the proposal put all of these loans (due to their floating rate and/or balloon structure) into category 2[7], but the proposed LTV calculation would prevent us from recognizing the value of the additional collateral. Therefore the proposal could easily push the risk weight on such loans even beyond the 100% risk weight assigned to commercial loans to 150% or even 200%.

From the standpoint of the bank making such loans, its capital position could be better off if it entirely excludes the borrower's home from the collateral package. Surely this is not in the interest of safe and sound banking, nor is it in the interests of these borrowers, whose ability to raise funds for their business would be impaired and whose rates would be increased significantly to reflect the additional equity needed to risk-weight the loan at 150 or 200%.

C. We do not believe that secured loans should potentially have risk weights above the 100% that is applicable to unsecured lending, including credit cards.

[6] The others are underwriting standards, housing price declines and increased unemployment.

[7] Loans must be reported and risk-weighted as residential mortgages if 51% or more of the collateral value is attributable to one or more SFR's. The proposal's formula calculates LTV based only on the value of the residential property; we have confirmed with the Federal Reserve that the proposal's LTV calculation will not allow inclusion of any non-SFR collateral that may be pledged to the loan.

D. This proposal discourages good relationship banking. Under the current framework, a closed-end senior and junior lien on the same property, are risk-weighted at 50%[8]. However, under the current proposal, if one of the loans has a balloon or floating-rate structure the risk weight on both loans is doubled or even tripled. This has at least two negative effects: first, it discourages relationship banking, and knowing your borrower is one of the best possible credit practices. Second, it motivates the bank to sell the (normally larger) first lien into the secondary market to mitigate the effect of the higher risk weighting, thereby increasing the demand for GSE credit guarantees and decreasing bank profitability while not actually reducing the bank's risk.

E. Balloons are an entirely valid risk mitigant on single-family lending, yet the proposal raises the risk weighting on such loans from 50% to 100% or more. Balloon payments on consumer-oriented term loans mitigate interest-rate and credit risk, and allow community banks to originate good loans on SFR's and keep them on their books. About 10% of our bank's loans outstanding are closed-end senior liens on SFR's, and virtually all of them have balloon payments. As noted above, our SFR loans have the lowest loss rate in the entire bank.

Very large banks have a greater range of options for managing their credit- and interest-rate risk on 30-year amortizing mortgages than do community banks. Raising risk-weights on balloon structures would hurt community banks' ability to continue to do mortgage lending on competitive terms with larger players.

F. Floating and freely adjustable rates are an entirely valid risk mitigant that should not contribute to pushing a loan above a 100% risk weight. Floating-rate home-equity lines of credit (HELOC's) are an excellent low-cost credit choice for many consumers and small-business owners, who correctly see them as lower-cost and more reliable sources of funds than credit-card borrowing, which is also priced on a floating-rate basis. For sound interest-rate risk management reasons, revolving credit is normally priced at a floating rate, not at a fixed or adjustable rate.

We see no evidence that prudent banking decisions to grant floating-rate loans secured by SFR's have contributed to industry losses. Home-equity loans, even during the recent housing crash, experienced losses that were drastically lower[9] than the closed-end senior liens that are eligible for 50% risk-weighting. Again, the critical phrase here is prudent banking decisions. Banks that are using deceptive practices with consumers, poor underwriting or risk management should be dealt with through the existing mechanisms (compliance, safety and soundness exams, increased provisions to the ALLL).

5. **The proposals do not cover credit unions, which are significant providers of mortgage loans and other banking services.** (Questions 1 and 31 in Regulatory Capital)

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[8] Assuming a combined LTV of no more than 89%.

[9] The 2011 UBPR for all banks in the nation shows loss rates on Home Equity loans were 30-67% below loss rates on 1-4 Family Non-revolving loans

Safe and sound banking practices are safe and sound banking practices, whether practiced by a bank or a credit union. All capital requirements, including any new Basel III requirements, should be extended to cover credit unions.

6. **Whatever marginal gains in the safety and soundness of community banks may be achieved by this proposal cannot possibly be worth the very large costs and unintended consequences.** (Question 1 in both Regulatory Capital and Standardized Approach)

   Today's capital rules consider our company far more than well-capitalized with $143MM in tangible common equity. Our well-managed, conservative, safe and sound company would need to raise another $127MM of common equity:

   --$77MM to account for the unrealized securities losses associated with a rapid 300 bp rise in interest rates;
   --$38MM to replace Trust Preferred; and
   --$12MM for increased risk weights on loans and to meet higher capital ratios.

   The near-doubling of capital requirements combined with increased compliance costs must result in lower rates for depositors, tighter credit terms for borrowers and higher fees for all customers. Banks will shrink their lending to all sectors of our economy. It will push both consumers and businesses even further out of the banking and toward the far less-regulated shadow banks.

   The Agencies do not appear to have performed the rigorous cost/benefit analysis that should be imperative for these sweeping changes that will affect virtually all sectors of the economy.

For all of the above reasons and more, we agree with FDIC Director Thomas Hoenig when he recently said that regulators should start over and focus on "a simpler alternative that takes us back to the basics."

We look forward to improvements in regulatory practice that promote a healthy economy and a safe and sound banking system.

Sincerely,

Donald L. Sturm Chairman	Koger L. Propst President	Susan M. Sturm Vice-Chair

Section II-Detail Reponses to Questions asked in the NPR's, with supporting data from our own banking experience.

Comments on Proposed Standardized Approach for Risk-Weighted Assets

General Comment: We heard in conversations with regulators that the proposals on asset risk-weights did not come from the Basel III agreement but instead represent U.S. regulators' efforts to address some of the problems they saw in the recent U.S. financial crisis. If so, we note a virtually complete absence of hard data in the proposals as to how these remedies actually fix the real problems that occurred. Much of our bank's loss experience during this period contradicts the general statements made in the NPR about risk and loss of various asset types.

Response to Question 8 regarding so-called High-Volatility Commercial Real Estate exposures. The proposal simply states that "supervisory experience has demonstrated that certain [ADC] exposures present unique risks for which [they] believe bank[s] should hold additional capital."

A. Neither industry data in the UBPR nor our own experience support the notion that such loans are uniquely or materially riskier than other types of credit when the economy slows. Our bank's loss rate on classified "HVCRE" exposures, for example, is virtually identical to that on classified C&I loans, which would continue to be risk-rated at 100%.

   UBPR data from the industry as a whole do not support the idea that "HVCRE" lending is riskier than unsecured lending, such as credit cards, which continue to be risk-weighted at 100%. First, HVCRE loss rates, even in the depths of the recent real-estate bust, have consistently been far lower than unsecured credit-card loss rates.[10] Second, losses in "HVCRE" have not been more volatile than losses in credit card portfolios. During the worst of the real-estate crisis, loss rates in each segment actually rose by virtually the same amounts.[11]

   If notwithstanding the data above, regulators believe that so-called HVCRE loans "present unique risks", the agencies should reflect that by using their existing rules, such as implementing the CRE concentration guidance and ensuring that banks apply loan-loss percentages that reflect a more negative experience.

B. The proposal would be difficult to implement, significantly burden borrowers who are pass-through entities for tax purposes, and essentially preclude banks from using release prices, a standard repayment mechanism.

   1. Difficult to implement. How is "capital . . . internally generated by the project" to be measured and accounted for? What is the definition of "capital" in this context? How is the owners'/principals' compensation to be considered and general corporate overhead to

[10] Ranging from a low of 4% of credit card loss rates in '07 to a high of 80% of credit card loss rates in '11, for all banks in nation.
[11] 138 bp's of annual losses in credit-card portfolios, 156 bp's for "HVCRE" loans, per the UBPR for all banks in nation, '07-'09.

be paid? How is transfer pricing to be considered when one commonly-controlled company provides services/products to the company that is our borrower? None of this is addressed in the NPR. If the agencies have not been able to grapple with them, it will be next to impossible for banks to write contractual loan covenants on these matters.

2. Borrowers who are pass-through entities for tax purposes routinely report taxable income during the life of the project. Cash to pay the taxes due is normally distributed out of these entities to pay the owners' associated tax liabilities. The borrowing entity itself does not record a tax expense. In that case, how are distributions to pay taxes to be made?

3. Release prices are a standard repayment mechanism for the portions of the completed properties that are sold during the life of the project. When, for example, commercial condo units that are part of a larger project are sold, the bank agrees in advance to release its lien on the units in exchange for payment of release prices that progressively reduce the bank's LTV in the remaining units, and ensure the bank is paid off well before all the units are sold. If the borrower sells the properties in excess of the release price they can use their net proceeds in ways they see fit, including paying their own overhead, making distributions to ownership for tax payments or other proper purposes. Placing higher risk-weights on this type of loan will only push banks out of a legitimate and valuable credit function, and borrowers into the shadow banking system.

For the above reasons, we see no valid purpose in burdening these loans and borrowers with the additional capital assessments. Nor is there a good reason to push these borrowers out of banks towards other financing providers.

Response to Question 9 regarding higher risk-weights on non-performing loans. "The agencies believe that a higher risk is appropriate to past-due exposures to reflect the increased risk associated with such exposures."

There is no question that non-performing loans have dramatically increased risk of loss. However, we have two concerns with the agencies' approach.

A. Foreclosed properties are risk-weighted at 100%, yet most non-performing loans would be weighted at 150%. Banks that believe they will maximize their economic recovery by working with their borrowers rather than moving to immediate foreclosure will be penalized by doing so. What is the purpose? Not every banking problem can or should be micro-managed by assessing more capital.

B. Banks should and do recognize the increased risk of non-performing loans through provision to the ALLL. Methodology for the ALLL is closely scrutinized at every safety and soundness exam. If reserves are inadequate, examiners can and do require increased reserves and improvements to the methodology.

By its nature, increased provision to the ALLL takes money out of Tier 1 capital and creates an immediate need for banks to replenish Tier 1 dollar-for-dollar in order to maintain steady capital ratios. The requirement to add separately to Tier 1 is duplicative.

At the risk of repeating ourselves, we believe the agencies should rely on their evaluation of banks' loan loss reserves, and ensure careful and rigorous methodologies therefor, rather than resort to the blunt instrument of higher capital levels.

Comments on Regulatory Capital and Capital Ratios Proposal

Questions 6, 7 & 8 regarding the capital buffer framework and the definition of executive officers

A. The regulation implements a new definition of executive officer, very different from what is in Reg O. We recommend that regulators apply a single, consistent definition of executive officer.

B. Combining the capital buffer framework with inclusion of AOCI in common equity Tier 1 makes it more difficult for management shareholders of S-corporations (about a third of U.S. banks) to do tax and dividend planning. Normally such banks pay out sufficient dividends to cover shareholders' tax payments. However, capital levels will be so unpredictable if AOCI is included in Tier 1 capital that it could be difficult for management to pay such tax-based dividends considering the potential consequences to capital ratios of an adverse move in interest rates. C-corporation shareholders, by contrast, will face no such issues as corporate taxes are a non-discretionary line item of expense.

Questions 15 & 16 regarding inclusion of unrealized gains and losses on Available-for-Sale securities in Tier 1 capital.

We have provided initial comments on this concept in our cover letter. Here we add to those comments.

We respectfully disagree with a number of the agencies' assertions in the NPR justifying this change. For example, the agencies state that "unrealized gains and losses on [municipal general obligation bonds] are **more likely** (emphasis added) to result from changes in credit risk and not primarily from fluctuation in a benchmark interest rate." We believe this assertion is simply false on its face. The market for the vast majority of municipal paper is very stable as evidenced that heretofore municipal bonds have rarely defaulted. Credit spreads in this market are generally quite stable. Most price fluctuations in this market have been driven first by changes in the underlying Treasury yield curve, second by changes in marginal tax rates, and only in minor degree by changes in creditworthiness.

Prices of other bank-eligible fixed-income investments are also driven primarily by the Treasury yield curve. Loss in market value due to decline in credit-worthiness is rarely a significant factor; when it is, it is well-addressed via the OTTI process discussed more fully below.

Question 15: To what extent would a requirement to include unrealized gains and losses on all debt securities whose changes in fair value are recognized in AOCI: i) result in excessive volatility in regulatory capital . . . iii) affect the composition of the bank['s] securities portfolios and iv) pose challenges for bank[s'] asset-liability management?

A. The volatility in our regulatory capital would be tremendous, as noted in the body of our letter, even though we have a conservative balance sheet, are very well-capitalized and have only modest interest-rate risk.

Regulators continue to encourage banks to plan (as they should) for adverse interest-rate moves, but as shown above it would be virtually impossible for even the best management to ensure that their banks would always remain well-capitalized under adverse interest rates if this proposal were to be implemented.

Furthermore, the primary impact to a bank of an interest-rate driven decline in the market value of its securities is its ability to raise funds by borrowing against them. This liquidity risk is best dealt with in the context of liquidity risk management and supervision, and contingency funding planning.

B. Composition of bank securities portfolios. None of the possible changes in composition of bank portfolios as a response to the resulting extreme volatility of capital levels are conducive to long-run safety and soundness:

1. Shift funds into investments that will not be marked to market, such as bank-owned life insurance. Not only do such investments normally carry more interest-rate risk but they are illiquid as well.
2. Reduce the average time to repricing of the bank's portfolio. Normally this will mean lower earnings for banks. If regulators already deem a bank's IR exposure to be satisfactory, why would they want to push banks to reduce their earnings?
3. Put additional securities in the HTM bucket. The central challenge for bank investment portfolio managers is to manage the balance between risk and reward for each of their securities, every day. This is what regulators should want them to do. However, to the extent that portfolio managers need to artificially protect the bank's capital levels by putting securities into the held-to-maturity bucket, their ability to manage liquidity risk, interest-rate risk and credit risk are materially reduced.

C. Challenges to asset-liability management. The critical problem here is not asset-liability management (which will be made more challenging) but capital planning. How can bankers feel comfortable paying dividends or knowing they have satisfactory capital structures when a rate shock could turn the bank's capital position around overnight, with the attendant regulatory and public perception consequences?

Question 16: What are the pros and cons of an alternative treatment that would allow U.S. bank[s] to exclude from regulatory capital unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate? . . . Are there other alternatives that the agencies should consider (for example, retaining the current treatment for unrealized gains and losses on AFS debt and equity securities)?

A. We strongly believe that the agencies should choose the last option mentioned in this question, which is to retain the existing treatment. The most important safety-and-soundness aspect of the current approach is that banks write off any and all unrealized losses on their investments that are deemed Other-Than-Temporarily Impaired, i.e., that portion that represent true expected loss of principal. As long as banks are properly implementing this OTTI requirement — and we see no evidence of systematic abuse — we believe there are no significant downsides to maintaining the existing treatment. By contrast, the downsides of reflecting the gains/losses in Tier 1 common equity are enormous, as discussed above.

B. Historic cost accounting combined with loan loss reserves, impairment analyses and disclosures has over time proven to be a far superior approach to providing investors and regulators with valuable information about the organization's position than has marking to market, which has all too often been seriously abused under the guise of sophisticated modeling.

The idea that a <u>partial</u> mark-to-market can work well is misguided. One important goal of accounting rules is to allow valid comparisons across institutions. However, just about every ratio having to do with capital will become significantly non-comparable across banks.

--How will regulators be able to properly compare one bank's capital position with another, particularly since C-corporations will reflect the losses net of tax effects, and S-corporations (approximately a third of all U.S. banks will reflect them without such a moderating effect)?

--Today's method of assessing deposit insurance rates in part based on capital levels will be completely untenable as capital ratios will become even farther removed from the risk of actual failure.

--How are regulators to be able to properly evaluate a bank's classified-to-capital when unrealized gains/losses change every day and peer asset quality ratios are so skewed by irrelevant items such as loan/deposit mix and tax status?

<u>Questions 17 & 20: Eligibility criteria for Additional Tier 1 and for Tier 2 instruments</u>

There appears to be a drafting problem in section III, Definition of Capital[12]. Specifically, sections III.A.2 and III.A.3 define when Trust Preferreds can be included in Additional Tier 1 and Tier 2 capital. We gather that the criteria listed are intended to mirror the language in existing indentures. For the most part they do, and it should not be a problem for banking companies to know whether their instrument complies or not. However, para. 5.iii of each of these two sections contains the following criterion for an instrument to qualify:

> "Prior to exercising the call option, or immediately thereafter, the banking organization must A) either replace the instrument . . . or B) Demonstrate . . . that the organization will continue to hold capital commensurate with its risk."

This requirement may belong elsewhere in the regulation, but not in the section that defines the criteria necessary for an instrument to qualify. By definition, exercising the call option will

[12] Section references are to sections in "Supplementary Information" and they correspond in the Text of Common Rule to Subpart C§__.20.

always be in the future if the bank currently has Trust Preferreds, whereas the bank needs to determine if the instrument qualifies today. The language above was not in the Federal Reserve's original model language for Trust Preferred indentures. Including this language as written would inadvertently exclude Trust Preferred from qualifying, when it is the clear intent of regulators to allow it to qualify.